

STRICTLY CONFIDENTIAL (FR) CLASS I-FOMC

*Material for*  
*Staff Presentation on*  
*Long-Run Ranges*

*July 2-3, 1996*

Chart 1

Velocity of M2 and Its Opportunity Cost

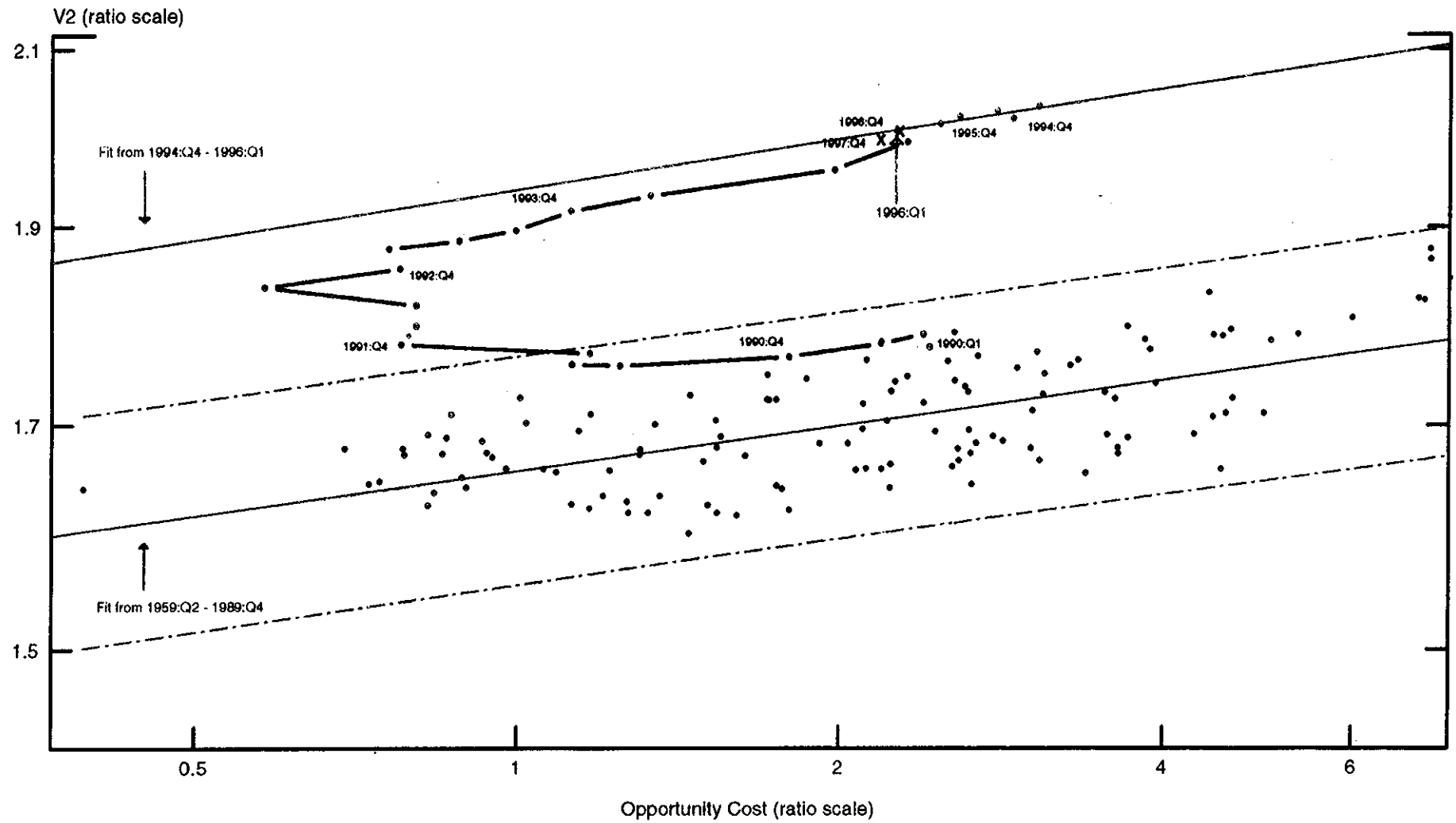
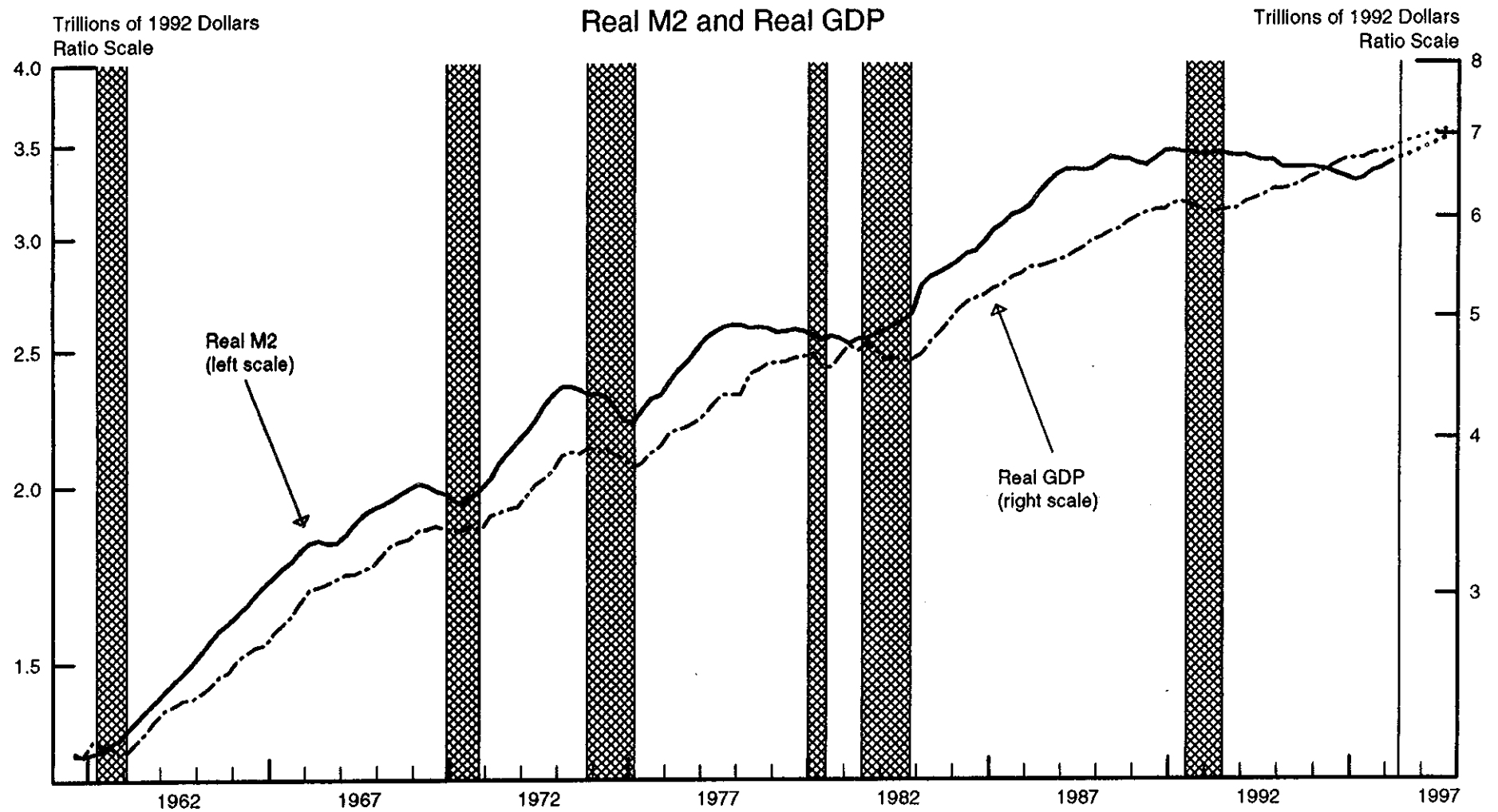


Chart 2



Note: Real M2 is deflated by the chain-weighted price index for GDP.

**Table 1**  
**Growth of Money and Credit and Alternative Ranges**  
**(Q4 to Q4, percent)**

	Staff Projections		Ranges		
	1996				
	Baseline (Greenbook)	Tighter	Alt. I (Current Ranges)	Alt. II	Memo: 1995:Q4 to June
M2	5	4-1/2	1 to 5	2 to 6	4.8
M3	6	5-3/4	2 to 6	3 to 7	6.3
Debt	4-1/2	4-1/2	3 to 7	3 to 7	4.8 <sup>a</sup>
Memo:					
M1	-1-1/2	-2-1/2			-1.5
Adjusted for Sweeps	7	6			7.3
Nominal GNP	4-1/2	4-1/2			4.9 <sup>b</sup>
1997					
	Baseline (Greenbook)	Tighter	Alt. I (Current 1996 Ranges)	Alt. II	
M2	5	3	1 to 5	2 to 6	
M3	6	4-1/2	2 to 6	3 to 7	
Debt	4-1/2	3-1/2	3 to 7	3 to 7	
Memo:					
M1	0	-3			
Adjusted for Sweeps	5	2			
Nominal GNP	4-1/2	3-1/2			

a. 1995:Q4 to May.

b. 1995:Q4 to 1996:Q2 (Greenbook projection).

July 3, 1996

FOMC Current Monetary Policy  
Donald L. Kohn

The situation facing the Committee, as many of you remarked yesterday, is one in which the economy is operating around its estimated long-run capacity with the odds perhaps skewed toward growth above potential, but there are few signs of increased price pressures. In these circumstances, the decision facing the Committee at this meeting would seem to be whether the possibility of emerging inflation pressures is high enough to warrant an immediate tightening of policy, or whether policy should remain unchanged, pending further information. That choice, in turn, would seem to depend on a weighing of the risks and an evaluation of the costs and benefits of erring to one side or the other. Many of the possible rationales for each policy option appeared in the Bluebook, but I'd like to expand on a few of the major items.

On the unchanged policy side are two main arguments: One, that policy may already be restrictive enough to keep trend inflation from rising very much, if at all; and two, that it is worth waiting to get a clearer picture on that score because relatively little may be lost by a modest delay, even if tightening is needed.

Support for the argument that policy may already be well positioned comes importantly from the levels of real

interest rates relative to their historical values. As we've discussed before, these comparisons are tricky because other things certainly do not remain equal over time, so that equilibrium real rates vary. Nonetheless, past relationships can provide a starting point for assessing current financial conditions. As I showed in my briefing at the last meeting, a chart of real long-term interest rates against changes in inflation over the last 15 years indicates that those interest rates right now are around the value that on average in the past 15 years has been associated with stable inflation. At the short end of the yield curve, the real fed funds rate is close to 2-1/2 percent using the Philadelphia Fed survey of expected CPI inflation over the next year. This is a half point above its long-term average, and it hasn't come down much from last year; that is, by this measure, about three-fourths of the reduction in the nominal funds rate over the past year has been offset by decreases in inflation expectations.

Moreover, both short- and long-term rates probably would not react much to the choice of the unchanged reserve conditions of alternative B. Although the term structure of interest rates seems to have a modest firming of policy built into it some time in the next few quarters, that firming is quite modest and most market participants do not anticipate such a move until later this year, if at all.

The staff forecast sees neither the economy nor the level of interest rates as far from where they need to be to contain inflation, and such a judgment is important in assessing the costs and benefits to waiting. The possibility that the economy is now or soon will be producing beyond its potential implies that accommodative policy will extract an inflation penalty. But because the overshoot is unlikely to be large, the pickup in inflation would be small and gradual, and waiting to gauge the extent of actual inflation pressures probably would not foster a process that would be difficult to reverse. In the extensions of the Greenbook forecast in the long-run scenarios section of the Bluebook, a hike of only 50 basis points in the funds rate at the beginning of 1997 is enough to cap inflation, albeit at the slightly higher level than now prevailing.

There may be benefits to waiting as well. Although "unusual uncertainties" can be a cliché used by policymakers to avoid tough decisions, the behavior of prices and especially wages over recent years suggests that, with respect to the relationship of inflation to output, "unusual uncertainties" do in fact currently exist. With broad measures of inflation still well behaved and the early warning signs still mixed--as the cautionary reading emerging from the vendor delivery times in Monday's purchasing managers report is balanced against the quiescent nature of industrial commodity prices--the Committee might see itself as having

time to get additional information on the price and wage setting process. If the NAIRU is, effectively, lower than we previously thought, real interest rates will need to be lower as well than one might judge from history to accommodate a higher sustained level of production.

Most of these arguments for unchanged policy would seem most consistent with a view that at this stage of the business cycle policy should be directed at keeping inflation from rising, not to bringing it down further. To have much assurance that the latter outcome would prevail would seem more definitely to require a near-term policy tightening. But the case for firming may be broader than this, resting on a notion that short-term rates likely will need to be raised at some point even to keep inflation in check, and that waiting does risk complicating the conduct of policy down the road.

Although real interest rates may be reasonably positioned by historic standards, they need to be judged against persistent upside surprises to aggregate demand and the state of other financial conditions. And it is against this background that one could develop an argument that policy may be too accommodative for the opportunistic policymaker leaning hard against inflation upticks. After their increase this year, real long-term rates are noticeably below their levels in late 1994 and early 1995. While real GDP in 1995 ran below the growth of potential, final

demands still increased about 2 percent. Moreover, although long-term real rates have risen a percentage point or more since the turn of the year, they are only about half a point above their average levels in the spring and summer of last year. These later rates, crudely, might be associated with the three percent growth of GDP or final sales now projected for the first half of 1996, placing the economy perhaps slightly beyond its potential. Whether, in the face of strong aggregate demand, a half point rise is enough to keep the economy around the level of its potential--or even a bit below if you want to tilt inflation down--is an open question. In our new model, a half-point increase in intermediate-and long-term rates by itself cuts only about half that amount, that is, one-quarter percentage point, from annual growth in GDP over the next four quarters. The effect doubles when the dollar rises and the stock market falls, in line with historic relationships. We've seen the former but certainly not the latter. Not only has the stock market risen substantially, but the increase in Treasury rates has not fully shown through to private borrowers, given the narrowing of some yield spreads and the continuing aggressive posture of the banks outside the credit card area. That is, the rise in long-term rates may overstate the effective tightening of financial conditions.

In part reflecting the sense that financial conditions are not particularly restrictive, the Greenbook has,

in effect, an equilibrium funds rate above current levels, and has identified upside risks to the forecast. With the economy near its potential, it's not surprising the clear signs of added inflation presences have not emerged. If the economy is stronger than expected, they should do so with a lag.

Hence, if interest rates do need to be raised, the longer that adjustment is postponed, other things equal, the larger it will have to be. There are two reasons for this. One, the real rate will need to be more restrictive later, or restrictive for a longer period, to offset the additional stimulus from holding real rates too low now. Two, the nominal rate will need to rise by even more than the real rate as inflation expectations tilt up.

In concept, postponing rate increases in favor of larger rate increases later is not a problem if the Phillips curve is linear and inflation expectations do not respond asymmetrically, and if there are no constraints on upward rate adjustments. Staff work on Phillips curves has not been able to identify such nonlinearities or asymmetric reactions in labor and product markets. But the same may not hold for financial markets. Inflation expectations adjusted down to actual inflation only during the last half of last year. Financial market participants may be particularly prone to build price acceleration back in if they perceive the Federal Reserve as becoming more reluctant to

take anticipatory action to head off the possibility of higher inflation. In this regard, they might see a natural hesitancy to raise rates as being accentuated at this time by pressures on the Federal Reserve to test whether the economy could operate at a higher level on a sustained basis. Even if inflation expectations responded only slightly and normally in wage and price setting, an upward ratchet in financial markets would complicate the conduct of policy, in part by adding to market volatility and making more difficult the interpretation of incoming signals.

If the Committee were to tighten policy, it would be a surprise to markets, and the reaction could be considerable. As we said in the Bluebook, some extrapolation of any tightening is probably inevitable--perhaps more so from a 25 basis point move. Market participants would be unlikely to view the Committee as having taken the trouble to reverse its previous direction for only one quarter-point firming, and might view the action itself as suggesting that the Committee saw greater inflation risks and consequently the need for higher real interest rates than the market had perceived. But there are elements limiting the extent of the reactions. Unlike in 1994, policy has not been on hold for 17 months in an admittedly unsustainable posture and investors are probably not as exposed to a tightening. Moreover, in the 75 basis point easing of the last year investors have been subject to a limited adjustment in a

policy that was basically on track, so the concept would not be alien. The Committee's explanation of its actions, both in its announcement and in the Chairman's Humphrey-Hawkins testimony would be a chance to shape market perceptions.

If the Committee chose not to act at this meeting, but saw the risks as distinctly skewed toward a need for tightening, it might consider adopting an asymmetric directive. Especially if the Committee were concerned that in current circumstances it might be perceived as responding sluggishly to potential inflation pressures, it might want to signal its desire to act quite promptly--before the next scheduled meeting--should incoming data suggest a greater inflation threat. The publication of such a directive in late August should not restrict the Committee's actions if the asymmetry is adequately explained in the Minutes. Moreover, the Chairman's testimony in July would already have conveyed the Committee's concerns.